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SUBJECT: BP QUIETLY LAUNCHES MACROECONOMIC MODELING UNIT IN
EFFORT TO STRENGTHEN GOAJ ENERGY REVENUE MANAGEMENT

Classified By: Ambassador Anne E. Derse per 1.4 (b,d).

¶1. (C) SUMMARY: BP has quietly launched an intensive effort to help the Government of Azerbaijan better manage its anticipated billions of dollars in energy revenue. After years of discussions, the GOAJ agreed to place a BP-funded macroeconomic modeling unit at the State Oil Fund (SOFAZ). BP hopes the new macroeconomic modeling unit will improve GOAJ awareness of the dangers of mismanaging its oil revenues and promote a cohesive, long-term approach to economic decision-making within the GOAJ. BP Senior Economist Mark Henstridge told the Ambassador that high degrees of resource-dependency in economies like Azerbaijan's present enormous commercial risks to BP; BP Policy Advisor Jacob Nell (who had worked for several years as an advisor to Azerbaijan's Finance Ministry) more bluntly said that GOAJ mismanagement of its energy revenue presents the greatest risk to BP. BP believes that Azerbaijan has "two or three budget cycles" (e.g. until 2008 or 2009) to set up proper procedures for revenue management in order to stave off hyperinflation. Nell separately told the Ambassador that BP is also thinking of creating a trust fund to finance macroeconomic framework studies that would analyze the economic situation in Azerbaijan, another step to increase the public's awareness of the importance of proper economic management. Henstridge and Nell commented positively on the new GOAJ economic team led by Finance Minister Sharifov and Minister of Economic Development Babayev, and believe the new economic modeling unit will be a key tool for the team to get a better grip on the GOAJ budget planning and budget process.
END SUMMARY.

BP WORRIED ABOUT MACROECONOMIC RISKS IN AZERBAIJAN

¶2. (C) BP Senior Economist Mark Henstridge told the Ambassador in late July that high degrees of resource-dependency in economies like Azerbaijan's present enormous commercial risks to BP. In a separate August 24 meeting, BP Policy Advisor Jacob Nell more bluntly told the Ambassador that BP's biggest risk in Azerbaijan is the government's potential mismanagement of its oil revenues. With energy revenue in the State Oil Fund (SOFAZ) already at 1.5 billion and projected to double over the next few years, BP believes that Azerbaijan must set up proper procedures to manage its energy revenue as soon as possible. Henstridge said that, thanks to Azerbaijan's full participation in the Extractive Industries Transparency Initiative (EITI), the GOAJ has the proper procedures in place to transparently transfer funds to the State Oil Fund. The real question is

whether Azerbaijan has the proper planning structures to adequately control expenditure of its energy revenue. Based on his previous discussions with Azerbaijan's economic policy-makers, Henstridge is not confident that the GOAJ has the proper structures in place. He said that senior policy-makers routinely ask him, "How do we know how much to spend?" According to Henstridge, they also want to know which industries will create jobs.

13. (C) Henstridge believes that the GOAJ has "two or three budget cycles" (e.g., until 2008 or 2009) to set up the proper procedures for revenue management in order to stave off hyperinflation. If the current inflation rate -- reported by the GOAJ at 11 percent -- increases, Henstridge said that window will narrow, but he also believes increased inflation as well could force the GOAJ to make the right economic decisions. Henstridge noted that, with presidential elections looming in 2008, the GOAJ faces enormous political pressure to spend oil money now and demonstrate some concrete benefits to ordinary citizens. He commented that Azerbaijan already has seen a "sizable" increase in public spending, with a doubling in the state budget that could drive inflation. (Henstridge also commented that the GOAJ CPI is not a good measure of inflation, a view shared by IFIs and the embassy.) Henstridge noted that Azerbaijan's political pressures are compounded by Azerbaijan's annual budget cycle. According to Henstridge, the solution would be to create a medium-term spending plan that is linked to the GOAJ budget process. Through the new economic modeling unit at SOFAZ, BP is hoping to steer the GOAJ in the right direction. Henstridge also mentioned that BP is keeping its support for the modeling unit quiet in order not to be seen as infringing on GOAJ sovereign authority.

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NEW ECONOMIC MODELING UNIT AT SOFAZ

14. (C) Since late 2004, BP has been working quietly with Oxford Economic Forecasting and SOFAZ to create an economic modeling unit that can help the GOAJ decide how to spend its energy revenue. BP and SOFAZ finally signed a Memorandum of Understanding on the modeling unit in early August, and on August 24, Jacob Nell of BP's Policy Department briefed the Ambassador on the initiative. Nell told Ambassador that the MOU negotiations between BP and the Oil Fund regarding the unit had been difficult due to the lack of cooperation between different government ministries. The Oxford Economic Forecasting group is currently delivering the model and training Oil Fund staff. BP and State Oil Fund Executive Director Shahmar Movsumov plan to unveil the macro unit in a closed-door presentation to GOAJ ministers at the end of September.

15. (C) At the presentation, the ministers will see that if the government spends too much, it will lead to higher inflation and possible macroeconomic instability. Nell said that BP hopes this meeting will spark additional dialogue about the government's responsibility to control expenditures. Nell also told the Ambassador about possible plans by BP to create a USD 1 million trust fund managed by the IMF or World Bank that will finance macroeconomic framework studies to further publicize the need for fiscal discipline as oil revenues increase. Henstridge believes that a "network of mature voices," internationally recognized economists, will be necessary to convince both senior Azerbaijani government officials and the broader Azerbaijani public of the need to rein in GOAJ spending. According to Nell, BP also is drafting a white paper on the State Oil Company, BP, and the next phase of economic cooperation in Azerbaijan, due to be delivered to President Aliyev in October.

¶6. (C) Nell said that Azerbaijan was fortunate to have political stability and leadership that had a long-term economic vision that included liberalizing the economy. He specifically mentioned the reform efforts of Finance Minister Sharifov, Economic Development Minister Babayev, State Oil Fund Executive Director Movsumov and National Bank Chairman Rustamov. Henstridge echoed these remarks, specifically singling out Finance Minister Sharifov for his good work in establishing SOFAZ. While the economic team is strong, BP believes it needs a "bigger picture" understanding of the budget process and the need to manage public expectations and spending pressures. Henstridge and Nell believe the new modeling unit will provide a useful tool. Nell noted that the GOAJ's ability to "manage" the domestic political situation will be helpful, commenting that he believes Azerbaijan would follow path of "incremental progress" as it develops.

¶7. (C) Nell noted that the political "old guard" remains a barrier to true political and economic reforms and that this group does not fear an increase in government spending or higher inflation. Nell felt that the GOAJ needed to get "burned" with higher inflation and macroeconomic instability in order to understand the need for fiscal discipline. He and the Ambassador agreed that it is important to strengthen the hand of the economic policymakers that understand the potential problems while trying to send the message to the political establishment of the inherent dangers in overspending in an economy unable to absorb additional inflows.

GOAJ PERSONALITIES/BIOGRAPHIC NOES

¶8. (C) Regarding the new Deputy Minister of Economic Development, Sevinj Huseynova, Nell said that she was intelligent, skilled in bureaucratic management, and from the politically powerful Nakhchivan area of Azerbaijan. Nell, who worked with Huseynova at the Ministry of Finance during

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the early 2000s, indicated that she is focusing on developing three key areas: a medium-term macroeconomic framework, a national development plan and a public investment plan. Huseynova, until her appointment at the MED, had been working with USAID-implementer DAI on the Public Investment Planning Project.

¶9. (C) Commenting on National Bank Chairman Rustamov, Nell said that he is one of the few in Azerbaijan "who really understands monetary policy," has extensive monetary policy experience and knowledge and has recently been building capacity at the National Bank, including in the banking supervision department. Nell said that since Rustamov's failed bid to become Prime Minister, his political influence has diminished, but he has proceeded to work hard at this current post. His ability to effect reform and build Azerbaijan's banking sector is limited by political factors, including the dominance of two state-owned banks.

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